Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Alpert Analyst: John Pavalasky Bill Number: SB 103

Related Bills: ______ Telephone: 845-4335 Amended Date: September 8, 2003

Attorney: Patrick Kusiak Sponsor: ______

SUBJECT: Regulated Investment Companies (RIC) Used to Avoid Tax

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ______.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ______.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ______.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ______. STILL APPLIES.

X OTHER - See comments below.

SUMMARY

This bill would expressly deny certain tax treatment of income earned from ownership of a Regulated Investment Company (RIC).

SUMMARY OF AMENDMENTS

The September 8, 2003, amendments replace the previous contents of the bill with the provision discussed in this analysis.

PURPOSE OF THE BILL

The purpose of this bill appears to be to ensure that banks cannot use a RIC to avoid California tax.

EFFECTIVE/OPERATIVE DATE

This bill states that it would be operative for taxable years beginning on or after January 1, 2003, while providing that no inference is to be drawn from the act with regard to litigation of the department's denial of this deduction for taxable years beginning before January 1, 2003.

POSITION

Pending.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	9/15/03
____ N	____ OUA	X PENDING		

LSB TEMPLATE (rev. 5-03)

ANALYSIS

FEDERAL/STATE LAW

Current Federal Law

A RIC, commonly called a mutual fund, is a domestic corporation or trust that at all times during the tax year is registered with the Securities Exchange Commission (SEC) under the 1940 Investment Company Act; meets gross income, diversification and earnings and profits (E&P) tests; makes certain required distributions; and elects on its tax return to be taxed as a RIC.

If it makes certain minimum distributions, a RIC is taxed only on the undistributed portion of its:

- ordinary income at the regular corporate tax rates; and
- net long-term capital gains at the corporate capital gains rate.

The RIC is not taxed on the amounts it distributes to shareholders through the mechanism of being allowed a dividends-paid deduction for the dividends paid to its shareholders. Other rules under the federal statutes governing the taxation of RICs generally preserve the underlying character of the RIC's income in the dividends paid to shareholders. As a result, a RIC is generally able to effectively pass through ordinary income, net capital gains, and certain other items to its shareholders without any tax at the RIC level.

Ordinary dividends that a RIC distributes to its shareholders are taxed to those shareholders just like other corporate dividends they might receive. Corporate shareholders of the RIC are allowed a deduction for dividends received. However, that deduction is allowed only to the extent that the RIC itself received dividends from corporate payors with respect to stock held in the RIC's portfolio. Shareholders of the RIC are not entitled to a dividends received deduction with respect to amounts treated as capital gain dividends.

A Real Estate Investment Trust (REIT) is designed to do for real estate investors generally what a RIC does for investors in securities (i.e., pool resources and get a return on capital without paying a corporate tax on the gain).

A REIT is taxed only on amounts not distributed to its shareholders, as follows:

- at regular corporate tax rates on undistributed earnings and profits and net capital gains; and
- at the highest corporate tax rate on net income from foreclosure property.

Like a RIC, the REIT is allowed a dividends-paid deduction for amounts paid to its shareholders as dividends, so the REIT in effect isn't taxed on the amounts it distributes to shareholders. Again, specific statutory rules under the REIT taxing statutes generally preserve the character of the REIT's income in the dividends paid to shareholders, thus effectively allowing it to pass through its earnings and profits, net capital gains, and net income from foreclosure property to the shareholders without any tax at the REIT level.

A dividend received from a REIT by a corporate shareholder of that REIT is not considered a dividend for purposes of the dividends received deduction.

Current State Law

California conforms, with certain modifications, to Subchapter M of the Internal Revenue Code, relating to RICs and REITs.

California conforms to the federal treatment of a RIC except that the undistributed portion of net long-term gains are not treated as capital gains but instead are treated as ordinary income and are taxed at the regular corporate rate. Also, a modification was made to substitute the state code section reference relating to the dividends received deduction for the federal code section reference to reflect that California difference.

California conforms to the federal treatment of a REIT except that the undistributed portion of net long-term gains and foreclosure property, instead of being subjected to a separate excise tax as under federal law, are treated the same as other ordinary income realized by the REIT and are taxed at the regular corporate rate. In addition, a modification was made to substitute the state code section references relating to dividends received by corporate beneficiaries for the federal code section reference relating to the dividends received deduction.

With respect to an affiliated group of corporations engaged in a unitary business, California requires that the dividend be eliminated from the income of the recipient when one of the corporations pays a dividend out of its share of the unitary income to its parent corporation that is also a member of the unitary group (R&TC Section 25106). The State Board of Equalization (SBE) has explained that the purpose of R&TC Section 25106 is to prevent double taxation for formula apportionment purposes. (See *Appeal of CTI Holdings, Inc.*, 96-SBE-003 (February 22, 1996).)

<u>THIS BILL</u>

This bill would explicitly deny corporate shareholders of a RIC a dividend deduction for earnings in a RIC that are not from stock dividends for taxable years beginning on or after January 1, 2003. Legislative intent language would prohibit any inference from being drawn from the operative date of the amendments made by the bill with respect to any matter governed by the RIC provision of the R&TC for taxable years beginning before January 1, 2003. Thus, the bill allows taxpayers previously taking this deduction to challenge the department's denial of this deduction for taxable years beginning before January 1, 2003.

PROGRAM BACKGROUND

Some banks are taking the position that the interest income on their loan portfolio disappears from the California tax base when they utilize a RIC structure. That is, through friendly intermediaries and through a series of transactions, some banks have established corporations to which the bank then contributes a portfolio of loans that it has made to third-party customers in exchange for shares in that subsidiary. The bank then registers the subsidiary with the SEC as a RIC. Thereafter, when the RIC subsidiary receives interest payments on the loan portfolio, it pays all of the interest income to the bank as a RIC dividend and claims a deduction for the amount of the dividend under the RIC rules.

Based upon this structure, the bank then takes the position that:

- the RIC subsidiary has no net income that would be subject to California tax because the dividends paid by the RIC are tax deductible; and
- dividends received by the bank from the RIC subsidiary are eliminated under R&TC Section 25106 as a dividend paid to a parent corporation that is unitary with its subsidiary.

The banks justify this result through a comparison of the language in R&TC Section 24872(h), relating to REITs, and R&TC Section 24871(e), relating to RICs, since both sections deal with California modifications to the federal provisions relating to restrictions applicable to dividends received from REITs and RICs.

The SEC has indicated that it is considering withdrawing the registration of certain RICs. Revocation of registration would be for public policy purposes because the banks are transferring traditional banking activities to these RICs, and what they are doing apparently violates the intent of the 1940 Investment Company Act. In addition, there is a question as to whether there is a valid transfer of the loan portfolios to the RIC as the bank is keeping the transfer “transparent” to its customers and retaining all control over the loan portfolios.

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida and *Michigan* do not recognize the unitary method of taxation. Florida begins the computation of the Florida tax base with federal taxable income on a Florida consolidated return while only firms actually engaged in business activity in Michigan are subject to the Michigan single business tax (SBT).

Illinois, Massachusetts, Minnesota, and *New York* compute the tax base on a combined return of the unitary group by starting with federal taxable income. However, the dividends received deduction and the deduction for income or franchise taxes are not allowed in computing Massachusetts taxable income.

FISCAL IMPACT

This bill would explicitly prohibit taxpayers from taking this deduction for taxable years beginning on or after January 1, 2003, and it would generate cost savings because appeals and litigation would not be required in order to sustain the department’s disallowance of the deduction for those years.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Prospectively, this bill closes what some corporate taxpayers believed to be a technical statutory loophole. Contrarily, departmental staff believes that there are credible arguments against using a RIC structure to deduct the same income twice and that this bill simply clarifies existing law.

Based on information presented in a recent article (August 7, 2003) by a staff reporter of The Wall Street Journal, the banks that created RICs in 1999 and 2000 have gradually shut down the practice over the last two-years. The same article indicates, however, that it is not known if more such funds remain active. At this time, it is not possible to verify if identified banks are continuing to deduct RIC dividends as these banks have yet to file returns for 2002 and 2003.

Previously the department has scored this proposal with significant revenue gains based on the taxpayer's position regarding current law. Assuming that most taxpayers have discontinued the RIC practice, it is unlikely the previously projected revenue gains based on the 2000 taxable year actually exist. Therefore, the potential revenue effects have been reduced to reflect the new information. Absent this legislation, use of the RIC structure to avoid tax may recur in future years.

This proposal could have the following revenue effects depending upon the correct interpretation.

Estimated Revenue Impact of SB 103 As Amended 9/8/03 [$ In Millions]			
Interpretation of current law:	2003-04	2004-05	2005-06
Taxpayers' Position	$10	Minor Gains	Minor Gains
Department's Position	Unknown Minor Gains Annually		

Revenue Discussion

The number of corporate taxpayers that created RICs (for purposes of avoiding tax on otherwise taxable income) that remain active, the amount of such income, and the tax rate of corporations that use the RIC structure would determine the revenue impact of the bill. For taxpayers identified as using the RIC structure, the tax effects of deducting dividend income twice totals approximately $46.8 million for the 2000 taxable year. The tax effect in 2003 is estimated at approximately one-quarter of this level, or $10 million.

ARGUMENTS/POLICY CONCERNS

The SEC as well as some banks will support this bill because they believe that the use of the RIC structure in this manner is improper.

The banks making use of this RIC structure will oppose this change. They argue that R&TC Section 24872 subdivision (h) explicitly provides that dividends paid by REITs to California corporate shareholders may not obtain the benefit of the exclusion from income under Section 25106, whereas the statutory provision relating to RICs (R&TC Section 24871(e)) explicitly negates the application of only Section 24402. The banks, thus, take the position that dividends received from the RIC subsidiary are excluded from the bank's taxable income pursuant to R&TC Section 25106.

LEGISLATIVE STAFF CONTACT

John Pavalasky
Franchise Tax Board
845-4335
john.pavalasky@ftb.ca.gov

Brian Putler
Franchise Tax Board
845-6333
brian.putler@ftb.ca.gov